COUNCILMEMBER DONNA FRYE

City of San Diego
Sixth District

MEMORANDUM

DATE: **September 10, 2007**

TO: **David Wescoe, SDCERS Retirement Administrator**

FROM: **Councilmember Donna Frye** Donna Frye

SUBJECT: **SDCERS IRS Voluntary Compliance (VCP) Submission**

Please provide to me copies of the following letters from the IRS to SDCERS and/or Ice MIller:

Letter from IRS dated June 7, 2006
Letter from IRS dated June 13, 2006
Letter from IRS dated August 31, 2006
Letter from IRS dated February 13, 2007
Letter from IRS dated February 20, 2007

For your convenience, I have attached a March 14, 2007 letter from IceMiller to Mr. Paul Hogan, Internal Revenue Agent, wherein the letters referenced above are marked.

In addition to the above letters, please provide to me copies of correspondence (letters, e-mails or facsimilies) from the IRS regarding the matter of SDCERS VCP Submissions.

Thank you for your prompt response.

CC: Honorable City Council
Honorable Mayor Sanders
City Attorney, Michael Aguirre
Independent Budget Analyst, Andrea Tevlin
Stanley Keller, Independent Monitor

DF/ks

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March 14, 2007

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VIA FEDEX

Mr. Paul C. Hogan, ID # 91-07322
Internal Revenue Agent/EP Specialist
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Internal Revenue Service
915 Second Avenue-Mailstop 510
Seattle, WA 98174-1001

Re: VCP Submission #911659038 and Related Form 5300 Determination Letter Application for the San Diego City Employees' Retirement System

Dear Mr. Hogan:

We have prepared this letter in response to your letter dated February 13, 2007. We have set forth your questions in **bold** and our responses in regular type. Per our discussion on March 8, 2007, all 415 issues in your letters dated February 13 and February 20 will be addressed in a submission to you on March 20, 2007.

We appreciate the time and effort that has gone into your letter and we appreciate the involvement of the Manager of Voluntary Compliance and other officials at Employee Plans in reaching this point on this complex matter.

A. **VCP Submission: Presidential Leave Issue:**

1. **Some discrepancies were noted in your 8/31/06 response and the related Exhibits you submitted in regard to the Presidential Leave Program.**

First, the POA letter of 8/31/06 on page 3 and the new Exhibit 12 included as part of your Exhibit 2 state that five union presidents have been impacted by this failure. It was noted that Ron Newman has not been listed as an affected participant impacted by this issue, and the Exhibit provides no information in regard to this individual. Yet your Exhibit 2E seems to mention this individual in connection with the Presidential Leave Program. Please explain.

Second, the new Exhibit 12 Supplement that was included as part of Exhibit 2 (associated with your 8/31/06 letter) suggests that Harry Eastus was

affected by the Presidential Leave Program starting on 1/1/91. However, the information in Exhibit 2E seems to indicate that he took over as union president on 3/4/89. It seems as if he would have been impacted by this failure prior to 1/1/91. Please explain.

Response to A.1.

Mr. Newman was not mentioned in the actual VCP filing because, although he served as a union president, the union did not remit contributions for him. Rather, he purchased service for the period during which he was on leave.

SDCERS has now located records showing that Mr. Eastus began leave effective February 10, 1989, in order to serve as union president. See the Creditable Service Record attached as Exhibit A.1. We apologize for the confusion in the dates in our earlier submissions.

2. **The new Exhibit 12 Supplement that was included as part of Exhibit 2 (associated with your 8/31/06 letter) does not disclose how the "Base Pension Amount, Monthly" was determined. In order to evaluate the proposed correction method for this failure, information must be submitted that shows what impact Union salary had on that computation of the "Base Pension Amount, Monthly".**

Response to A.2.

The "Base Pension Amount, Monthly" reflected in the new Exhibit 12 Supplement in Exhibit 2 to our August 31, 2006, letter is calculated, in part, based on the Monthly Salary (final average salary determined monthly) of the member. (The calculation of "Base Pension Amount, Monthly" consists of the Base Pension, COLA Annuity and Surviving Spouse Annuity components. Only Base Pension is calculated based on salary; however, this is the largest part of the Base Pension Amount, Monthly.) The member's union salary was taken into account in determining the Monthly Salary. Therefore, in the case of Mr. Collins, Mr. Farrar, Ms. Italiano and Mr. Saathoff (but not Mr. Eastus, whose Monthly Salary was based only on City salary), the member's Monthly Salary was higher than it would have been without the union salary and the benefit was also correspondingly higher.

We would be happy to provide calculations illustrating the impact of calculating benefits only on the basis of City salary. However, before doing so we wish to confirm exactly what calculations you would like to see. That is, do you want to see the impact of excluding the union salary on the calculation of monthly benefits in isolation? Or do you wish to see the impact of completely ignoring service with the union except to the extent of continued City employment and salary, which will impact in some cases not just the inclusion of the union salary for benefit calculations, but also the number of years of service and the total employee contributions?

3. **The language in the Plan regarding the Incumbent President Program seems to indicate that the member's required employee contributions will also be based on the union salary received by the plan participant in addition to any compensation paid by the City. See Plan Document Exhibit G-10/21/02**

Resolution. Are these employee contributions being picked up under Internal Revenue Code ("Code") section 414(h)? If so, is it by the City or the Union? Does Code section 414(h) allow for such an action since none of the Unions have adopted the Plan, and the picked up contributions are not coming out of City compensation?

Response to A.3.

Per the attached schedule (Exhibit A.3), employee contributions were deducted from union salary and remitted to SDCERS by the unions for Collins and Farrar. Italiano purchased her service via a plan-to-plan transfer and a personal check. Saathoff's contributions were picked up from his City salary.

SDCERS has confirmed that it treated Collins' employee contributions deducted from his union salary as post-tax contributions. However, SDCERS is not aware of how the union treated these contribution amounts on the Forms W-2 the union issued to Collins.

SDCERS has also confirmed that it treated Farrar's employee contributions deducted from his union salary partially as pre-tax contributions ($11,404.27) and partially as post-tax contributions ($2,347.73). Again, SDCERS is not aware of how the union treated these contribution amounts on the Forms W-2 the union issued to Farrar. Thus, it appears that SDCERS incorrectly treated a portion of Farrar's contributions as though they had been picked up by the union. As noted below, we concur with the Service's position that the employee contributions that were deducted by the union from employee salaries were not able to be picked up under Code Section 414(h). Therefore, these amounts should have been treated as post-tax contributions. SDCERS will correct its coding of these contributions so that all of Farrar's contributions deducted from his union salary are treated as post-tax contributions. In addition, SDCERS will inform the union of this change.

4. **In terms of the years in which the Unions paid employee contributions directly to the plan based on union compensation paid to the union presidents, please indicate whether such contributions were picked up under Code section 414(h). If so, please explain how this is acceptable under Code section 414(h) given that none of the affected unions have adopted the Plan and the picked up contributions are not associated with any City paid compensation.**

Response to A.4.

We concur with the Service's position that the employee contributions that were deducted by the union from employee salaries were not able to be picked up under Code Section 414(h). As noted in our response to A.3., SDCERS will correct the coding of Farrar's contributions which were treated as pre-tax and will inform the union of this change.

B. VCP Submission: IRC 401(a)(9) Minimum Distribution-DROP-June 7, 2006 Letter

After careful consideration of the original information presented in your original letter of June 7, 2006 and the additional information and comments contained In your 8/31/06 correspondence, it is still uncertain from your correspondence whether you have explicitly described an actual plan document failure in regard to Code section 401(a)(9) that is applicable for the TRA'86/GUST timeframe. Your letter hints that the Plan's language in regard to the minimum distributions may not have been complete enough to satisfy the overall form requirements of the statute. While the individuals from the Service (at the August 10, 2006 meeting) did encourage the Plan to present all identified problems to the Service's VCP program, there was no representation that we would ignore the program requirements that apply to VCP submissions. Rev. Proc. 2003-44 Section 10.01 states that the Service will not make any investigation or finding under VCP concerning whether there are failures. Therefore, the Service will not, under VCP, make a determination as to whether the Plan's DROP distribution options made before October 2005 adhered to a reasonable good faith compliance with Code section 401(a)(9), whether Board Rule 12.21 is acceptable under Code section 401(a)(9) and whether Board Rule 12.20 is in compliance with Code section 401(a)(9). Nor will the VCP compliance statement contain an explicit statement as to whether the steps taken by SDCERS to revise the DROP provisions do not result in a per se violation of Code section 401(a)(9). It must be pointed out that the plan language relating to final regulations under Code Section 401(a)(9) is part of the EGTRRA remedial amendment period and this language will be reviewed when the Plan is submitted for a determination letter on the EGTRRA tax law changes in accordance with Rev. Proc. 2005-66. In terms of operational compliance, with Code section 401(a)(9) in regard to DROP, the taxpayer is free to submit a private letter ruling following the procedures set forth in Rev. Proc. 2007-4 outside of this VCP submission. In the end, your VCP submission should be revised to delete these requests. The DROP participants whose required minimum distributions did not commence on time will be fixed as originally proposed in your letter of April 19, 2006.

Response to B.

Based on our February 26, 2007, discussions, SDCERS will proceed as follows:

- SDCERS will rely on our position that the DROP distributions options allowed before October 2005 were a reasonable, good faith compliance position.
- SDCERS will not submit a private letter ruling request with respect to DROP options prior to October 2005.
- Instead, SDCERS will submit Board Rules 12.20 and 12.21 in its next determination letter application (Cycle C filing).

- With respect to those DROP participants who did not commence a benefit prior to their required beginning date, those will be corrected as indicated in our filing of April 19, 2006.

- SDCERS will delete its additional VCP requests with regard to the DROP participants.

C. **VCP Submission: Overpayment of Benefits-10% Disability Issue**

After reviewing your initial 6/13/06 letter as well as the additional comments and information contained in your response dated 8/31/06, Item 15 (pages 12 & 13), the Plan's proposal not to seek repayment from the affected participants is acceptable and makes sense given all submitted facts and circumstances. However, simply classifying the overpayments as an unfunded pension liability that will be recovered through the Plan's normal funding and actuarial procedures is not acceptable. Overpayments that are not recovered from the affected participants become the responsibility of the plan sponsor. Under EPCRS, we require the plan sponsor to reimburse the Plan for any un-recovered overpayments by making a special, immediate contribution to the Plan before the end of a specified period that is to be set forth in the terms of any compliance statement or closing agreement. Your proposed correction methodology for this failure should be revised to delete the references to increases in the Plan's unfunded liability and simply state that the overpayments will be paid to the Plan by the plan sponsor(s) through special, supplemental contributions.

Response to C.

SDCERS has calculated the amount that is due as a result of this overpayment (total overpayment plus interest) to be $1,000,283.65.

SDCERS agrees to delete references to increasing unfunded liability and agrees to bill the City for the overpayments as a special supplemental contribution by the plan sponsor (the City of San Diego).

Per the comments of Jim Holland in our meeting on February 26, 2007, we understand that for purposes of this contribution and all the other contributions for which SDCERS will bill the City, the definition of special, supplemental contributions will be contributions in excess of the annual required contribution ("ARC") as defined in the most recent actuarial valuation, June 30, 2006, Actuarial Valuation produced by Cheiron, dated January 2007. (A copy of Letter of Transmittal is attached as Exhibit C.) Therefore, for the year ending June 30, 2005 (which establishes rates effective for FYE 2007), we understand the "baseline" to be $162.0 million in contributions by the City of San Diego. SDCERS will consider amounts received above that amount in the July 1, 2006 – June 30, 2007 plan year as special, supplemental contributions. For the year ending June 30, 2007, we understand the "baseline" to be $137.7 million in contributions by the City of San Diego. SDCERS will consider amounts received above that amount in the July 1, 2007 – June 30, 2008 plan year as special, supplemental contributions.

D. VCP Submission & Determination Letter: Cashless Leave Conversion Issue

1. **We have considered your initial letter of 6/19/06 plus its attachments as well as the additional comments and information provided in your response dated 8/31/06, item 17 (pages 26-27) plus attachments. The terms of the Plan do not appear to comply with the form requirements of Code section 401(a) because the language appears to offer some plan participants a cash or deferred election (as defined In IRS Regs. 1.401(k)-1) in regard to the donation of their annual leave in exchange for additional pension benefits. Such an arrangement cannot be part of a qualified defined benefit pension under Code section 401(a). We must also point out that under the specific terms of City Ordinance 19126 that was adopted on 12/3/02 there is no indication that this benefit was to funded via employee pickup contributions under Code section 414(h). In fact, the specific terms of the City Ordinance that created the "cashless leave" benefit clearly indicate that this is to be an unfunded pension liability. It will be funded by possible increases in the City's contribution rate and the City will not be transferring to the Retirement System the cash equivalent of the Annual Leave underlying the conversion to Creditable Service or the extension of the period of DROP participation in these Annual Leave conversion transactions. See City Ordinance No. 19126 adopted on 12/3/02. Given this information, it is not immediately obvious whether there is an actual operational failure involving a failure to follow the terms of the Plan as stated in your letter of 6/19/08 and its accompanying analysis. It is also not clear as to whether there is a legal obligation under the Code for the City to immediately turn over (to the Plan) $519,163.79 that is associated with the value of the donated leave in order to fund the leave conversion benefit.**

Response to D.1.

SDCERS has provided the attached declaration (Exhibit D.1.) regarding the implementation of the leave conversion program. It continues to be SDCERS' position that this does not constitute a cash or deferred arrangement. We would ask you to consider PLR 200708006, issued 2/23/2007, where the Service ruled that certain employer contributions to a health care trust were not taxable to the employee even though the contributions were based on leave conversions. Although this PLR deals with a health plan, we believe that the holding in the ruling is of interest here because there is a strong similarity in the facts.

The following chart shows a side-by-side comparison of the facts of the PLR as compared to the facts of SDMC 24.1310(c) and the 2002 MOU:

Facts of PLR 200708006	**Facts of Cashless Leave**
Coverage under the health care plan (Plan) will be automatic for eligible employees	The Cashless Leave program is similar because participation in SDCERS is automatic for Members of Local 145.

Facts of PLR 200708006	**Facts of Cashless Leave**
Employer will contribute to the Trust amounts as specified in the Plan or by resolution of the Employer.	The Cashless Leave program is similar because the SDCERS Board determines the amount to be contributed to the fund.
No other person will be permitted to make contributions.	SDCERS different from this trust because it is a contributory plan, funded by employer and employer contributions. However, the SDCERS Board interprets the Cashless Leave program as only requiring employer contributions.
The Employer's contribution will include the following: discretionary contributions to be made by the Employer on behalf of all participating employees; contributions of all or a portion of employees' accumulated unused vacation and sick leave upon retirement; and contributions of all or a portion of employee's annual excess vacation and sick leave that would otherwise be forfeited or paid out at year end.	The contributions to the Cashless Leave program are based upon the cash equivalent of unused annual leave accrued after 7/1/2002. This provision is also similar to the PLR in that the PLR deals with a contribution of leave that would otherwise be forfeited or paid out at year end. The Cashless Leave program clearly states that post-7/1/2002 leave cannot be cashed out.
In accordance with the Plan's procedures and prior to the beginning of each Plan year, the Employer will designate the amounts for the discretionary Employer contributions to be contributed to the Trust and the percentage or fixed amount of the vacation and sick leave to be contributed to the Trust	As with the PLR, the value of the conversion is not determined by the employee. It is determined by the Board and as established by the plan document. The amount of service credited is based upon the employer and employee cost of service credit as determined by the SDCERS Board.
All contribution amounts will be determined in the sole discretion of the Employer and under no circumstances will employees be permitted to decide the discretionary Employer contributions to be contributed to the Trust or the amount or percentage of their vacation and sick leave to be contributed to the Trust.	As stated above, the Board has the sole discretion to determine the amount of service that can be purchased. The only choice the employee has is when to have the leave converted – either before entering DROP or at the end of the DROP period, when the leave is converted to a DROP period extension.

At our meeting February 26, 2007, the Service raised the point that, if a member did not purchase service prior to the DROP period, the leave remained available for the member to use as a leave day. We agree that that is the case. However, it also appears from the facts of the PLR that those individuals would also be able to use their leave days prior to the conversion because the conversion was done at year end based upon leave that would otherwise be forfeited or paid out. We think in virtually every situation leave that has not been converted can be used

for its original purpose (e.g., a sick day). We are not aware of any design whereby a person would lose the ability to use outstanding leave until it has been converted.

Consequently, SDCERS still asserts that the Cashless Leave program is not a cash or deferred election, but rather a mandatory leave conversion program that fits within the Service's prior guidance and current rulings.

2. **In order to be able to issue a favorable determination letter and resolve the open VCP submission with an acceptable correction method that fully resolves this qualification failure, we are requesting that your initial VCP proposal of June 19, 2006 be revised in the following manner:**

   (a) **The terms of the Plan must be retroactively amended to remove this benefit from the Plan.**

   (b) **SDCERS will have to revise their records and remove the additional benefits and service that were generated by the donated leave from all affected participants. This applies to DROP and non-DROP benefits. If overpayments have been made by the Plan, then it will have to try and recover any overpayments.**

   (c) **The City will have to restore the donated leave to the affected participants if they are still employed by the City. If the affected participants are no longer employed by the City, then the City will have to make a cash payment to the employee. Such a payment will be considered as taxable compensation.**

Response to D.2(a), (b) and (c).

At this time, SDCERS does not agree to the proposed correction. We believe that the facts of the Cashless Leave program are such that the Service should not conclude that it constitutes a CODA. After reviewing this submission and our arguments, if the Service still reaches that same conclusion, then we request that any correction be prospective only and that there be no recalculation of employee benefits.

Of the members listed in our VCP on Cashless Leave, 24 are Active, 18 are Active and in DROP, and 1 is Retired. All of these members are covered by the Memorandum of Understanding, which was arrived at through collective bargaining between the City and Local 145. Requiring a change in the plan would require not only a change in SDMC, but a change in a benefit that was bargained for. Additionally, these benefits are protected by the contract clauses of the federal and state Constitutions, which limit the power of a public entity to modify its own contracts with other parties, including but not limited to its employees. Board of Administration v. Wilson (1997) 52 Cal. App. 4th 1109, 1130. Under this doctrine, vested contractual rights to pension benefits accrue upon acceptance of employment, and such rights may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity. (Id. at 1132).

Since the submission of our VCP, there have been no more Cashless Leave conversions. Therefore, under the terms of the SDMC and the MOU, the leave balances for affected members of Local 145 will automatically be converted to DROP period extensions.

E. **VCP Submission & Determination Application: 401(h) Issue**

1. **After reviewing your initial 6/22/06 letter as well as the additional comments and information provided in your response dated 8/31/06, item 19 (pages 14 through 17 plus several Exhibits) and the DL Item 23 (page 31), the terms of the Plan and the Plan's operation did not comply with the form and operational requirements relating to Code section 401(h) and Code section 401(a)(2) especially given the express terms in the 3/31/97 City ordinance and Plan section 24.1502(a)(5). In the end, plan assets were indirectly used to pay for the 401(h) benefits at all times, and this design did not allow the Plan to comply with Code sections 401(a)(2) & 401(h). We do not agree with your assertion that the $63,462,590 in 401(h) contributions associated with the 1997-2002 plan years is simply a funding shortfall that should be recovered through the Plan's normal funding and actuarial procedures.**

Response to E.1.

As we discussed at our February 26, 2007, meeting, SDCERS is not prepared to concede to the Service's position on this correction. We have asked the Service to re-look at the position asserted in our VCP filing and in the 8/31/06 letter, and you have agreed to do so. We have submitted additional material on this point in a letter dated March 13, 2007.

We have acknowledged that the City's action did not result in additional contributions coming to SDCERS, but rather the City's action resulted in underfunding of the pension assets. SDCERS and the City are not subject to the funding rules of Code Section 412. Therefore, under the Code, the City is permitted to contribute less than would be required for a private sector plan. The City's decision to underfund SDCERS is the subject of separate lawsuits, as Ms. Parks reported at our meeting. In addition, this funding shortfall has been recognized in the actuarial reports. However, we strongly assert that the issue of underfunding of SDCERS should be considered a separate issue from whether there was a valid 401(h) account.

2. **In order to have an acceptable VCP correction method that fully resolves this qualification failure, we are requesting that your initial VCP proposal of June 22, 2006 be revised in the following manner:**

(a) **The $63,462,590 must be described as an immediate obligation to the Plan that must be paid to the Plan by the City and that it will not be treated as an unfunded pension liability. Like the other amounts associated with this failure, the City must agree to repay this amount to the Plan on a faster schedule as discussed further on page seven of this letter, and it must be added to the other amounts described in your letter of 6/22/06 that are owed to the Plan. Therefore, the corrective amount that is owed to the Plan as a result of the described**

401(h) failure has increased by $63,462,590 (before interest). This amount will have to be adjusted for earnings through the date of correction and be added to the other amounts associated with this failure that are considered immediate obligations. Please include revised exhibits that document the amount to be repaid the Plan as a result of the 401(h) failure.

(b) **In order to fix the plan document failures, the terms of the Plan need to be retroactively amended to remove all mention of Code section 401(h), section 24.1502(a)(5) and any other language that states that the Plan would pay for health benefits with plan assets. A revised corrective amendment needs to be submitted.**

Response to E.2.(a) and (b).

To put this matter in context, as we discussed, adding this correction to our original VCP would mean that the City would be required to immediately contribute almost $100,000,000 to SDCERS. As of June 30, 2007, interest on the principal amount of $63,462,590 would be $33,376,949. Therefore, the total interest and principal would be $97,199,539.

As we discussed at our meeting, the City's budgeting cycle is such that adding such an amount to the FYE 2008 budget would be very difficult. Exhibit E.2(a) shows the budgeting process. Therefore, the earliest that this amount could be reasonably added in any significant degree would be for the FYE 2009 budget.

With respect to the amendment that you requested to repeal the 401(h) language and the 24.1502(a)(5), SDCERS will prepare a draft ordinance for submission for the repeal of the 401(h) language. A draft of that ordinance is attached as Exhibit E.2(b)-1. The City Council has already undertaken to repeal the language contained in SDMC 24.1502(a)(5). A copy of that ordinance is attached as Exhibit E.2(b)-2.

F. **VCP Submission - Request for a five year Repayment period for Amounts owed to the Plan associated with the 401(h) health benefits-retiree health expenses and the 415(b) failure.**

We have carefully considered your request to allow the plan sponsor to have a five year repayment period in order to reimburse the Plan for the payment of City expenses, or certain employee contributions that were turned over to the Plan or to restore overpayments that were mistakenly paid to some plan participants. We believe that the requested repayment period is too long given the limitations of the VCP program and is not consistent with how we have handled similar requests in past EPCRS situations. Given all of the facts and circumstances, a more reasonable repayment period that could be allowed under VCP would be approximately 18 months. Five years is just too long. Please revise your correction proposals to call for a shorter repayment time. Please remember to include this reasonable repayment period for the amounts owed as a results of the overpayments associated with the Plan's 10% disability benefit and the additional amounts owed that are

associated with the 401(h) retirement health expenses failure and the 415(b) overpayments.

Response to F.

As we discussed on February 26, 2007 meeting, SDCERS is not prepared to concede on the issue of the payment period. Further, we discussed the difficulty in increasing the City's contribution in FYE 2008 at that meeting and have summarized those concerns again in our response to questions E.2(a) and (b) above.

We think it is important to recognize that the SDCERS Board has taken this aggressive initiative using the VCP process because of its independent status as a fiduciary. The Board considered various alternatives in considering the appropriate repayment period. Given the information that was presented to the Board, the Board determined that the five year repayment period was appropriate for the VCPs. However, the Board did recognize that a different period could be prescribed by the Service in the course of the VCP process. As Jim Holland observed, the City's employer contribution has decreased, according to Cheiron's calculations, by $20-24 million, in the past year. Jim raised the concept of "capturing" that amount for this correction. Such an approach would approximate the 5-year program that SDCERS had suggested (prior to the addition of the $63,462,590 additional correction).

We would like to continue pursuing a repayment period with the City as soon as we hear back from the IRS on the $63M issue.

As stated above, the Board anticipates that it would enter into a binding agreement with the City with regard to payment obligations under VCP settlement.

G. New Operational Failure for VCP (item 20 of your 8/31/06 letter, page 17)

I have reviewed your 8/31/06 letter (page 17) along with Exhibit 26 and your other letter of 6/22/06 with its Exhibit A. You have clearly described an operational failure where Plan provided benefits to certain individuals that were not in accordance with the terms of the Plan in the 2004-2006 plan years. Under the Internal Revenue Code, a qualified plan must operate in accordance with the terms of a written plan document. Changes in a state law do not override this basic requirement of the Internal Revenue Code. If the Plan has to change its operation to comply with a state law or some court case, then the plan sponsor needs to amend the Plan by the end of the plan year in which such changes were effective. Under the Code these changes are considered discretionary changes. Given your own disclosure of the issue, please add this failure to the VCP submission and revise the Exhibit 26 amendment to contain the proper retroactive effective dates that conforms the plan document to the Plan's operation in regard to this specific matter. I call your attention to Rev. Proc. 2003-44 Section 12.08(4)(b). The plan document cannot be changed retroactively under the Internal Revenue Code unless the Plan is retroactively amended to apply these discretionary changes, and only certain programs under EPCRS allow this action to occur. A change in administrative procedures will have to be made in order to ensure that needed discretionary

amendments to the Plan document are drafted timely and adopted by the plan sponsor in a timely manner so that the plan document conforms to changes in the Plan's operation.

Response to G.

SDCERS agrees to this correction. An additional VCP filing is attached as Exhibit G.

H. **Form 5300 Application Issues**

1. **Given the existence of the Technical Ordinance (See Exhibit 26 associated with your letter of 8/31/06) and the comments in your letter of 8/31/06 (page 20) it is obvious Plan's terms did not fully comply with all of the form requirements imposed by Code section 401(a). Some of the failures were discovered by your office and others were uncovered during the initial review of the form 5300 application by the Service. The Plan has never received an IRS determination letter and the remedial amendment period for TRA'86/GUST has been closed for some time. Many of the identified plan document defects go back to the effective dates of TRA'86/GUST. In order to fix the plan document defects many of the changes in the Exhibit 26 proposed amendment to section 24.1004 must have retroactive effective dates in order to fix identified problems with the plan document. Since the Code section 401(b) remedial amendment period has expired for TRA'86/GUST tax law changes the Plan cannot be retroactively amended to fix identified plan document failures unless the VCP submission is expanded. Please note that a favorable TRA'86/GUST determination letter cannot be issued unless the Plan is retroactively amended to fix the plan document failures. Please expand the VCP submission to acknowledge the plan document failures.**

Response to H.1.

SDCERS will expand its VCP to take into consideration this plan document failure. (An expanded VCP is attached as Exhibit G.) Retroactive effective dates have been added to the Technical Ordinance, which is attached as Exhibit H.

2. **In terms of your Exhibit 2 that is associated with your letter of 8/31/06 it is not clear if a good faith EGTRRA amendment was adopted timely to implement the higher compensation limits associated with Code section 401(a)(17) and for the QDRO rules of Code section 414(p) that now apply to governmental plans. It would seem as if some sort of EGTRRA good faith should have been adopted by the end of the GUST remedial amendment period or the end of the 2002 plan year. If there is a chance, that some required interim, good faith amendments for EGTRRA were not timely adopted by the plan sponsor, then please expand the VCP submission to include the additional failure.**

Response to H.2.

The Technical Ordinance has been revised as requested. See Exhibit H.

3. **Many of the amendments that are part of Exhibit 26 need to have retroactive effective dates. Currently, some of the corrective amendments do not have an effective date. Some of the proposed changes should be effective as of 7/1/89 while others may have a different date. Please revise the amendment to contain the correct effective dates.**

Response to H.3.

The Technical Ordinance has been revised as requested. See Exhibit H.

4. **Our prior letter raised concerns on whether section 24.0103 & 24.0902 of the Plan complied with Code section 401(a)(25) & Rev. Rul. 79-90. In your response (8/31/06 letter, page 21) you have proposed to have the Board adopt these factors via a "Board Rule". Since these "Board Rules" are to be part of the plan document, you must submit these documents to us so that they can be part of the proposed amendment and be associated with the determination letter application. They must also be evaluated for compliance with the above rules. The Board rules must specify the interest rates, mortality tables that have been used [since]July 1, 1989. We must point out that Board rules that are drafted like your Exhibit 18 (associated with your letter of 8/31/06) are not definitely determinable and will not satisfy this requirement.**

Response to H.4.

The SDCERS Board has periodically approved the factors that are used in benefit calculation. Attached as Exhibits H.4-1 and H.4-3 are Proposed Board Rules 8.41 and 8.90 that codify the interest rates and mortality tables, respectively, that have been used since July 1, 1989.

5. **Our previous letter raised concerns about whether several of the Plan's provisions provide definitely determinable benefits as required by Code Section 401(a) and IRS Regs. 1.401-1(b). In your response (8/31/06 letter, pages 21-22 & pages 27-28) you have proposed to have the Board adopt employee contribution rates, and interest paid on employee contributions via a "Board Rule". Since these "Board Rules" are to be part of the plan document you must submit these documents to us so that they can be part of the proposed amendment and be associated with the determination letter application. They must also be evaluated for compliance with the above rules. The Board rules must specify the rates that have been used [since] July 1, 1989. We must point out that Board rules that are drafted like your Exhibit 18 (associated with your letter of 8/31/06) are not definitely determinable and will not satisfy this requirement.**

Response to H.5.

See Proposed Board Rule 8.80 attached as Exhibit H.4-2.

6. **The DROP language that is present in plan section 24.1404(c)(6) is not definitely determinable and it needs to be addressed. Some sort of retroactive amendment will have to specify the rate or rates that have been used since the DROP was added to the Plan up through the current plan year. Similar to earlier Items #4 & 5.**

Response to H.6.

The DROP language that is present in San Diego Municipal Code § 24.1404(c)(6) is supplemented by Board Rules 12.20 and 12.21 and Proposed Board Rule 12.10(a). We believe the Board Rules satisfy your concerns. See Exhibit H.6.

7. **After reading your response in regard to the questions involving the Plan's death benefits (see 8/31/06-Pages 22-24) the terms of the Plan should be amended to contain a specific overall cap on the total amount of death benefits that will be provided by the Plan. This will ensure that the Plan terms are consistent with the requirement of IRS Regs. 1.401-1(b)1(i) with the incidental death benefit limitation. The use of one of the specific methods mentioned in your 8/31/06 letter would be acceptable. Please make this provision retroactively affective as of 7/1/89.**

Response to H.7.

All of these provisions relate to the death of a member while employed and therefore are subject to the incidental benefit rule contained in Treasury Regulation § 1.401-1(b)(2)(i). The Board Rules in H.4 are being amended to incorporate the 25% of cost test. Cheiron has run a preliminary test and the results indicate that the death and disability benefits should fall well within the 25% of cost test. Cheiron will issue a certification of the test results once those results are finalized. We will provide a copy of that certification to you when we receive it.

8. **We have reviewed the proposed amendment (Exhibit 26-associated with your letter of 8/31/06) in terms of the new language for compliance with Code section 401(a)(17) and page 24 of your cover letter. It is not clear if the proposed corrective amendment allows the Plan to meet Code section 401(a)(17) limits.**

   (a) **As noted in some of the other questions, the referenced Board rules were not included with the amendment. They must be submitted and made part of the proposed amendment and reviewed as part of the DL application. Please submit the missing documents and please keep in mind the rule on definitely determinable benefits.**

(b) **We do not believe that the family aggregation rules can be incorporated by reference. Also, the language in the amendment is not very clear that such provisions were only effective in the 1996 plan year. Please submit a revised amendment.**

Response to H.8.(a) and (b).

(a) The Board Rules are included in Exhibit H.4. However, the reference to Board Rules in the section dealing with 401(a)(17) has been deleted because of the amount of material that has now been incorporated into the Technical Ordinance.

(b) The Technical Ordinance has been revised as requested. See Exhibit H.

9. **As noted in the VCP item relating to the "cashless leave" issue, the language in the Plan must be retroactively amended to remove this benefit from Plan sections 24.1310(c), 24.1402 through 24.1404 and any other applicable plan section that references this benefit.**

Response to H.9.

As discussed above, SDCERS is not prepared to concede this point and therefore has not prepared the requested amendment.

10. **As noted in the VCP item relating to the 401(h) issue, the language in plan Article 24 Division 12, Section 24.1502(a) and other places in the plan should be retroactively removed from the terms of the plan document. A revised corrective amendment is needed. The language in the Plan does not meet the form requirements of Code section 401(h) and 401(a)(2).**

Response to H.10.

SDCERS is not willing to concede the retrospective operational point. But the SDCERS Board will propose to the City that the 401(h) language be removed prospectively. As noted above, the City Council is already taking action to remove Section 24.1502(a). See Exhibits E.2(b)-1 and E.2(b)-2.

11. **The definition of IRC 415 compensation that is part of the proposed amendment (Exhibit 26 of your 8/31/06) is still not acceptable for the following reasons:**

(a) **No retroactive effective date.**

(b) **The wording in the proposed amendment is still not definitely determinable since there are two choices in this regulation (1.415-2(d)(11)(i) or (ii)). Also, the term "W-2 income" is not used in the regulation. Please choose one of the definitions of compensation that**

is in this regulation and please do not use terms that are not referenced in the regulations.

(c) **The amendment did not include the exclusion relating to 414(h) contributions.**

(d) **The amendment did not include the GUST inclusions effective in the 1998 limitation year in regard to increasing the definition of compensation for IRC 415 purposes as noted in Code section 415(c)(3). Also, lacking is the additional adjustment that was added by CRA'00 effective in the 2001 or 2002 limitation year.**

(e) **Given Participant's ability to purchase service credit, the plan may need to add the IRC 415(c) limits. It is unclear if the specific proposed amendment language on page 16, Item 3 meets this requirement.**

Response to H.11.(a), (b), (c), (d) and (e).

See Exhibit H.

12. **In terms of the change to the Plan's definition of "Limitation Year", the proposed amendment is not acceptable because it does not contain an effective date.**

Response to H.12.

See Exhibit H.

13. **As noted in the VCP item relating to the IRC 415(b), (c) & (n) issues, the language in the Plan must be retroactively amended to further comply with Code Section 415 limits.**

Response to H.13.

See Exhibit H.

I. Litigation Update

As we discussed in our meeting, we have provided a litigation update. See Exhibit I.

J. Plan Update

In addition to the change that was made by the City Council with respect to domestic partners, the City Council also adopted Division 19, which is attached as Exhibit J.

We hope that this response fully addresses a number of the issues raised in your letter of February 13, 2007, except for those issues related to 415 compliance. Those issues will be

covered in a March 20, 2007 letter. We have agreed to many requests and hopefully resolved those to the IRS's satisfaction. We realize we have asked the IRS to reconsider several other issues and will be prepared to discuss those at any point.

Please let us know if further clarification is required and/or when we should schedule a follow up meeting.

Very truly yours,

ICE MILLER LLP

Mary Beth Braitman

Terry A.M. Mumford

Katrina M. Clingerman

jls

cc: Joyce Kahn (letter via email only – balance FedEx)
Andrew Zuckerman (letter via email only – balance FedEx)
James Holland (letter via email only – balance FedEx)
Maxine Terry (letter via email only – balance FedEx)
Joseph Grant (letter via email only)
David Wescoe (bound copy)
Roxanne Story Parks (bound copy and electronic copy)
Bob Wilson (bound copy)
David Arce (bound copy)
Christopher W. Waddell (bound copy)

DECLARATION

Under penalties of perjury, I declare that I have examined this submission, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of this submission are true, correct, and complete.

San Diego City Employees' Retirement System

By: Robert L Wilson Jr

Name: ROBERT L. WILSON JR

Title: ASSISTANT RETIREMENT ADMINISTRATOR

Dated: 3/14/07

EXHIBITS

Eastus' Creditable Service Record	A.1
Employee Contribution Schedule	A.3
Actuarial Report Letter of Transmittal	C
Declaration regarding Cashless Leave	D.1
Budget Schedule	E.2(a)
Ordinance repealing 401(h) language	E.2(b)-1
Ordinance repealing § 24.1502(a)(5)	E.2(b)-2
VCP Supplement on Plan Document	G
Revised Technical Ordinance	H
Board Rule 8.41	H.4-1
Board Rule 8.80	H.4-2
Board Rule 8.90	H.4-3
DROP Board Rules	H.6
Litigation Update	I
Plan Update	J